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No policy plan will be able to create lasting prosperity for a number of years. What is wrong with the [American] economy cannot be fixed quickly. The only way to return to long-term financial health and economic vitality is through an extended financial retrenchment. Until this is accomplished, prosperity can be achieved only by temporarily reversing the process, increasing the downside potential and delaying the bitter medicine.

***The Levy Forecast*, Feb. 19, 2003**

THE PROFIT TRAP

During the past two years, sharply rising consumer and government spending have prevented a deep recession in the United States from beginning. Business investment spending suffered its steepest fall. It has been widely recognized that its rebound is the indispensable condition for a sustainable U.S. economic recovery. There is no sign of that happening. Profit conditions are, of course, crucial. But they are inexorably worsening.

Focusing strictly on economic data, rather than the Iraq war, we see accelerating deterioration across the board. The question is whether or not a quick and positive outcome of the Iraq war will buy the economy a few more months of expansion. What truly matters are the looming, large imbalances and structural distortions that are the legacy of five or six years of unfettered money and credit creation.

Around the world, economies are sliding into recession, stock markets are crashing, interest rates are plunging and budget deficits are soaring — and above all, profits and business fixed investment are slumping. There has been nothing like it in the whole postwar period.

To find a comparable pattern, one has to go back to the Great Depression of the 1930s. Yet the extent of the decline varied immensely between countries. Quantitatively, the greatest part of the depression happened in the United States. Whereas U.S GDP fell almost 30% between 1929–32, it fell about 15% in France and Germany. In Europe as a whole, including France and Germany, it was around 7%.

Each phase of the business cycle is generated out of the preceding stage. In the 1930s, too, the synchronized global downturn followed a prior, synchronized global upturn. However, the famous stock market boom of the 1920s was purely American, not global. Nothing like it happened in the rest of the world.

In the 1920s, too, America played a key role in fostering Europe's economic recovery. But in contrast to the domestic spending excesses of the last few years, which impacted the world through the ballooning U.S. current account deficit, America's economic boost to Europe in the 1920s occurred through the capital account, that is, through massive lending. The current account in the U.S. economy's balance of payments was in surplus.

For the great majority of American economists, any review of what happened in the 1930s is a worthless exercise. Under the influence of Milton Friedman's *Monetary History of the United States*, it became the undisputed view among them that the *"monetary collapse from 1929 to 1933 was not an inevitable consequence of what had gone before. It was the result of the policies during those years… Alternative policies that could have halted the monetary debacle were available throughout those years. Though the Federal Reserve proclaimed that it was following an easy-money policy, in fact it followed an exceedingly tight monetary policy."*

In essence, this statement says first of all that any borrowing and spending excesses that happen during the boom are irrelevant; and second, that monetary policy is in any case all-powerful to prevent recession regardless of what happened before. No doubt, that is a pleasant message. At his famous speech to central bankers in Jackson Hole, Wyo., on Aug. 30, 2002, Fed Chairman Alan Greenspan virtually confirmed this view with the remark that a central bank, instead of pricking a bubble, should rather focus on possibilities to *"mitigate the fallout when it occurs and, hopefully, ease the transition to the next expansion."* In other words, enjoy the excesses.

That was, of course, the purpose of his record-setting rate cuts that he started on Jan. 3, 2001. By the end of 2002, 12 such cuts slashed the federal funds rate by 525 basis points to 1.25%, its lowest level in 40 years. At the same time, fiscal policy has fallen in with massive tax cuts. After a surplus of close to $300 billion in 2000, the Federal budget ended 2002 with a deficit of similar size and is heading towards $400 billion in 2003. That's quite a fiscal push, equivalent to more than 6% of GDP within little more than two years.

THREE KEY QUESTIONS

Together, this definitely represents the most egregious economic stimulus ever applied in history. The consensus view holds that these aggressive policies have been successful in preventing a deeper recession and that this assures the economy's recovery.

Mr. Greenspan keeps offering another promising explanation for the U.S. economy's comparatively excellent performance during the past few years — *improved flexibility of the economy and associated quickening of the adjustment process.* In Jackson Hole, he rejected any criticism of his tolerance and accommodation of the bubble, saying: *"Economic imbalances in recent years apparently have been addressed more expeditiously and effectively than in the past, aided importantly by the more widespread availability and more intense use of real-time information."*

Recessions are, inherently, the phases in the business cycle in which businesses and consumers liquidate their borrowing and spending excesses during the boom and adjust them to the sustainable long-term pattern of demand and output. How much economic pain this involves essentially depends on the extent of the prior excesses.

Assessing global economic prospects, we strictly distinguish between the U.S. economy's problems and those of the countries in the euro zone and Asia. They are of exactly opposite structural nature. The latter are economies with high rates of saving. In the past, these had their match in equally high levels of investment. But faltering investment in recent years has led to a chronic surplus of saving, implying a corresponding gap in domestic demand.

With nothing in sight that may reduce this structural savings surplus, either through lower savings or higher investments, the world is looking with desperation for another fix from the American growth machine. Our preliminary brief answer is that the American growth machine has been derailed.

According to popular spin, booming investment propelled U.S. economic growth during the past few years. In the view of the consensus, this created the excess capacities that explains the following profit and investment slump. It has always been our contention that the reality was an unprecedented consumption boom that essentially compressed the share of GDP still available for investment.

That is precisely what the official national income and product account (NIPA) numbers have been plainly telling. It shows most strikingly in the first place in sharply declining personal and national savings. National savings are down to a new postwar low of 15% of GDP, compared to 18.8% in 1998. What's more, its composition has dramatically deteriorated.

The share of business saving is down from close to 10% to almost zero, while the share of depreciation charges is up from 54% to 75%.

Assessing the U.S. economy's growth prospects, we ponder three questions that we regard as crucial.

(1) What exactly has broken the American boom?

(2) What is impeding its recovery?

(3) What is happening to these impediments?

All postwar recessions had their main cause in monetary tightening, responding to rising inflation rates. Faced with a credit crunch, businesses and consumers were forced to curb their spending. On the other hand, once the central bank loosed its shackles, spending and economic growth promptly took off again.

THE TWO CRUCIAL DIFFERENCES

What, exactly, is putting the present economic downturn radically apart from past cyclical experience in the whole postwar period? It is two things above all: *first*, its global synchronization; and *second*, its structural pattern. Both features have only one precedent in history: America's depression of the 1930s.

Japan's present case differs diametrically from the U.S. case in its international implications. With its current account in chronic surplus, it has been the world's greatest capital exporter for many years, attracting very little foreign capital. In contrast, foreign holdings of U.S. assets had a market value of more than $9 trillion in late 2002, more than $4 trillion of which was in stocks. Of equally singular importance is the U.S. role as importer of goods, accounting for 18% of world imports. Second in line is Germany with 7.6%.

We come to the crucial difference between the present global economic downturn and all its precedents since World War II. Reflecting little more than the liquidation of excessive inventories, the typical postwar recession in the industrial countries used to be sharp and brief. While declines in building and business fixed investment in equipment used to contribute a fair share to the resulting recession, their main force was inventory liquidation.

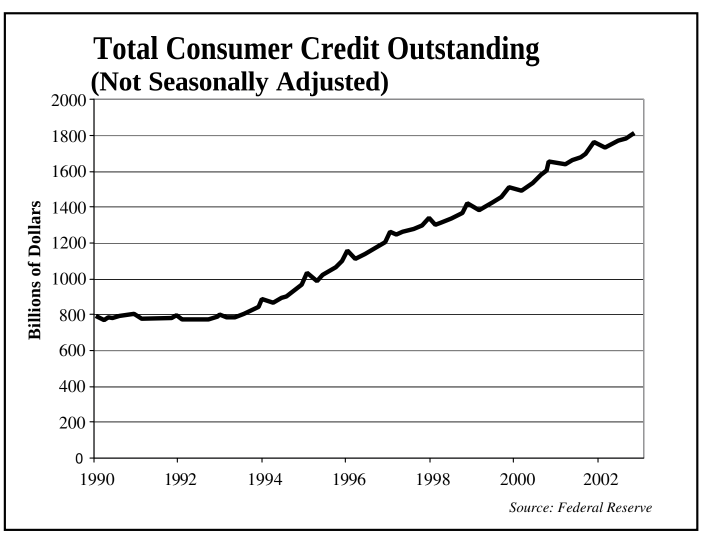
The present global economic downturn distinguishes itself from all prior postwar recessions through two novelties. The first one is its pattern. Its main force everywhere is an unusually sharp slump in business fixed investment; and the other one is its cause. Around the world, this downturn has started in the absence of monetary tightening. Worldwide, businesses are retrenching mainly due to profit troubles.

DROWNING IN A MONEY AND CREDIT DELUGE

Specifically in the United States, the crack in economic growth occurred abruptly in the third quarter of 2000 against the backdrop of rampant money and credit growth. Nonfinancial credit soared in that quarter by $1,014 billion and financial credit by $809.5 billion. Yet economic growth collapsed in nominal GDP from 7.3% in the prior quarter to 2.2% and in real GDP from 4.8% to 0.6%.

It is one of the ominous mysteries about the economic development in the United States that economic activity has apparently completely decoupled from unfettered money and credit growth.

Nonfinancial, private credit growth actually took an unprecedented quantum jump in 1996. During the first half of the decade, nonfinancial, nonfederal debt had grown overall by $1,670 billion, or at an annual average of $334 billion. But in the second half of the decade, total new borrowing shot up to $5,919 billion, averaging $1,183 billion per year. The same impetuous acceleration shows in the borrowings of the financial sectors. During the decade's first half, these sectors increased their borrowings overall by $1,663 billion, in the second half by $4,160 billion.



In last year's fourth quarter, total debt skyrocketed a record $665 billion (not annualized), comparing to simultaneous paltry GDP growth of $80.1 billion, both at annual rate. For each dollar added to GDP, $8.30 were added to overall indebtedness, both measured in current dollars. In essence, this indicates a complete disconnect between the credit machine and economic activity.

As to the consumer, he increased his spending on goods and services in the fourth quarter by $57.1 billion. His new borrowings of $220.8 billion (not annualized) also scored a new all-time record, again both numbers at annual rate. Included with the Fed's most recent consumer borrowing report was January data for terms of credit — new car loans. During

January, their interest averaged 2.97%, for an average term of 58.5 months, with 96% loan to value, and an average amount financed of $26,443. Reasonable? Five-year loans for a car? With the average owner facing a $500 monthly payment? And what about the damage to the sales price by the accumulating mass of second-hand cars?

Details from the fourth quarter GDP are indicative of a grossly distorted economy: Close to 40% of its growth owed to government spending, 71% to consumer spending, 16% to residential building and 9.6% to business fixed investment, while the surging import surplus subtracted 48%.

PROFIT CRISIS

Back to the first of our three above-mentioned questions: What exactly broke the U.S. economy's last boom? Definitely, it was not lack of money and credit. The economy is virtually drowning in a money and credit deluge. Manifestly, the economy's sudden crack had one main cause: a sudden slump in business fixed investment.

But what triggered that? The short answer is a corporate profit carnage that has been lingering for many years, and that worsened dramatically in the last few years. Considering the extraordinary importance of this point, let's take another look at the following profits chart, showing their development as a share of GDP since the 1960s.

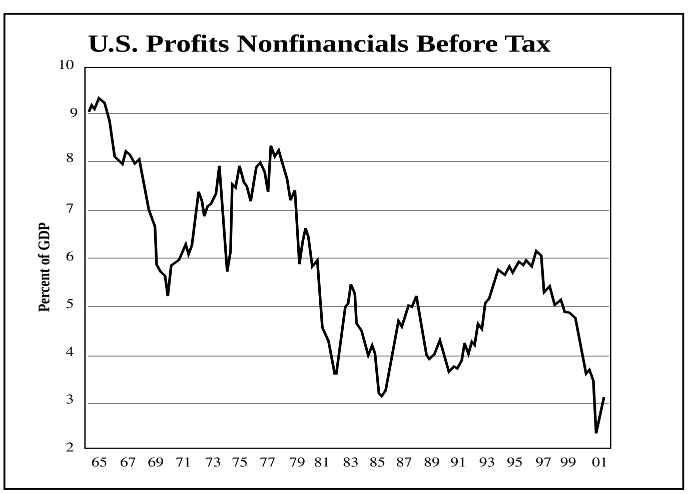
While Wall Street celebrated a profit miracle, the reality was America's worst profit performance in the whole postwar period.

According to widespread, popular perception, profits in the United States and around the world are being hammered by lack of corporate pricing power, mainly due to aggressive Asian competition. Deflation has become the new catchword in the economic discussion in America, supposedly explaining the economy's woes.

Our first critical argument is that the present U.S. profit carnage started in earnest as early as 1997, that is, at the height of the economy's boom. In the following four years to 2001, producer prices for finished goods increased altogether by 6.8%, or 1.7% per year. Over the same period, recorded productivity in the nonfarm business sector increased by 10%, or 2.5% per year.

Under these excellent price and productivity conditions, profits ought to have soared during these years. But even though the economy boomed, nonfinancial profits dived from 6% to 3.3% of GDP, their lowest level in the whole postwar period. But the chart also shows that badly performing corporate profits are by no means a new problem for the United States.

Measured as a share of GDP, they have been down most of the time. There were two pronounced recovery phases — in the 1970s and in the first half of the 1990s. The steep fall in the late 1970s/early 1980s has to be seen in connection with Paul Volcker's savage monetary tightening at the time. Rather ominous, though, appears the following poor profit recovery during the 1980s.



But most shocking and also most portentous is definitely the steep slide of profits since 1997, happening against the backdrop of extreme monetary looseness, low interest rates and a booming economy. Altogether, this allows no doubt anymore that the U.S. economy's protracted profit stress is not cyclical but of deeper-seated, structural nature.

It is a point that we have been emphasizing for years, pointing also all the time to the two major macroeconomic causes — a low rate of net investment and the exploding trade deficit. It has been and still is strict macroeconomic considerations that induced us years ago to flatly disavow the brouhaha about a profit

miracle in the United States. And the same considerations suggest to us that there is worse to come for profits and the economy.

CAPITAL-SPENDING CRISIS

The U.S. economy's structural predicament shows strikingly in two numbers: From the beginning of the U.S. economy's slowdown in the third quarter of 2000 until the fourth quarter of 2002, consumer spending has increased by $681.7 billion, or 7.8%, while business fixed investment in the nonfinancial sector fell $165.9 billion, or 12.9%. Profits are down 28.6% from their peak in 2000 and 36.4% from their 1997 peak. This is already the steepest fall in profits in the whole postwar period.

That increase in consumer spending, by the way, compares with a simultaneous increase in his indebtedness by about $1,400 billion. This horrendous debt number definitely makes a joke of Mr. Greenspan's assertion that the U.S. economy's comparatively excellent performance during the past several years has been largely due to *"improved flexibility of the economy and associated quickening of the adjustment process."*

Plainly, what effectively happened in the economy is the diametric opposite. The Fed, the government, Wall Street and the government-sponsored enterprises appear resolute in their determination to stonewall any spending restraint on the part of the consumer. In fact, his new borrowing binge on the back of rising house prices is hailed as a great policy success. Policymakers are deadly afraid that slower consumer spending may pull the rug out from under the economy. It may well cause the cataclysmal shock for the stock market that has yet to happen.

The frightening problem is that more than two years of unprecedented monetary and fiscal lavishness have completely failed to spur any revival in business investment. There is no hint of any relief in the twofold crisis of profits and capital spending. Even more disturbing is that for the first time since 1929–32, these policies have failed to stem the stock market's decline.

To understand the U.S. economy's woes, it is necessary to understand the causes of its profit woes. As noted earlier, the popular verdict of deflation makes no sense in consideration of the fact that the poor profit performance has been looming for more than five years. Nor can it be attributed to tight money and credit.

Our findings after close investigation are that the structural, profit-impinging influences began to develop in the early 1980s, but that they went to extreme excess during the boom years in the late 1990s. Altogether, we have identified a variety of such influences. They reside partly on the macro level, that is, in the monetary and fiscal policies pursued during the past 20 years. But they reside partly also on the micro level, resulting from the specific corporate strategies that developed under the new equity culture in the obsessive pursuit of quick maximization of shareholder value.

Yet there is a common denominator to both macro and micro influences. That's a gross neglect of capital formation. In the United States, the spending excesses went totally into overspending on consumption, leaving an economy that has become extremely lopsided toward consumption.

THE TWO MACRO PROFIT KILLERS…

The macroeconomic approach that we pursue in search of answers to these question focuses on the flows in the economy that impact aggregate business revenues, on the one hand, and aggregate business expenses, on the other. The emphasis is on the word *aggregate*. Changes in spending, saving, investing and, most important, taxing cause changes in profits through their effects on certain flows.

The obsession with shareholder value has given rise to virtual anarchy in many fields of economics. One of them is macroeconomics, meaning the study of the economy as a whole. To understand the U.S. economy's deteriorating profit performance during the past few years, it needs a macroeconomic perspective.

Applying this perspective boils down to posing and examining one single and simple question to all corporate activities: How does it impact business revenues in the aggregate?

From the perspective of a single firm, firing labor, for example, seems a straightforward device to boost a firm's profits as it reduces costs. Yes, but looking at the economy as a whole, the lower wage costs mean an equal lowering of consumer incomes which, in further sequence, reduces consumer spending at the expense of other firms' revenue and profits. For the economy as a whole, wage-cutting is clearly self-defeating as a device to increase profits.

…WEAK NET INVESTMENT

The people who implore deflation as the main cause of poor profits overlook that business revenues — looked at in the aggregate — have one major source that is generally crucial for profit creation, and that is their own net capital investment.

It is typically the single most important profit source because — looking at the business sector as a whole — it creates business revenue without generating expenses. The reason is that the investing firms capitalize this spending in their balance sheets. But to the manufacturer who produces and sells the machine, it generates a sale and revenue. No expense is incurred until the first deprecation charge is recorded. A very high correlation between movements of net investment and profits is historically notorious.

As noted earlier, Corporate America's profitability turned ominously bad during the 1980s. You remember, it was famous for its supply-side Reaganomics. In actual fact, there was no supply-side improvement in resource allocation. Fueled by easy money and wealth effects in the stock market, consumption increased its share of GDP growth over the decade by seven percentage points to 70%. Net nonresidential investment, on the other hand, increased modestly between 1980 and 1989 from $129.2 billion to $153.4 billion. As a share of GDP, it fell from 4.8% to 2.9%.

What actually happened during the decade was an unusual, sudden sharp divergence between gross and net investment, reflecting a massive shift in Corporate America's fixed investment stance towards short-lived investment, mainly high-tech equipment. Gross investment rose by $252.5 billion over the decade, or 70%, but depreciation charges soared by $228.3 billion, or close to 100%, leaving very little net investment. Only net investment, however, adds to profits, while depreciation charges add to expenses.

As earlier explained, net business investment is typically the economy's largest profit source. But this profit source literally dried up in the 1980s.

…AND A SOARING TRADE DEFICIT

At the same time, profits came under heavy attack from the emerging and soaring trade deficit, as consumers began to spend an increasing share of their income on imported goods. The crucial point to keep in mind here is that in the aggregate all incomes in an economy derive ultimately from business costs. The problem with a big trade deficit is that it diverts domestic spending towards foreign producers.

Conventional opinion holds that the soaring trade deficit squeezes business profits through price effects. It says that cheap foreign competition deprives domestic producers of their pricing power, as reflected in the declining U.S. inflation rates. No doubt, this contributes to the profit squeeze, yet it is not the main cause. By far the greatest part of the economy — services, retail and transportation, apart from airlines — is sheltered against foreign competition.

Nevertheless, we share the view that assigns a key role to the soaring trade deficit in hammering U.S. corporate profitability. But the devil is not in the price effects of the higher dollar, but in the massive loss of revenue that American businesses incur due to the outflow of domestic spending to foreign producers. The problem is that much of that money buying foreign goods comes from their wage bill. If it were not for the trade deficit, all this money would return to them as revenue by purchasing their products, bolstering their profits. Instead, the trade deficit slashes U.S. business revenues in relation to expenses.

The following table shows the development of U.S. nonfinancial profits during the 1980s in conjunction with

the two variables that we have identified as the main macro profit killers — lagging net investment and the soaring trade deficit.

THE MACRO SQUEEZE ON PROFITS (in $ billion)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
Net investment*	129.2	150.7	128.4	107.8	162.8	176.1	146.0	127.8	140.9	153.4
Current Account	2.3	5.0	-11.4	-44.0	-99.0	-124.2	-152.1	-167.4	-128.4	-105.6
Profits*	141.5	159.6	129.4	153.3	191.3	172.3	154.9	193.3	235.2	219.3

**nonfinancial sector*

All in all, it was in all three aggregates a rather poor development. Yet the years 1984 and 1985 stand out as years with strong jumps in net investment and profits.

The following table shows the development of the same three aggregates from 1992 to 2001 (in $ billion).

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Net investment*	97.8	131.1	160.3	203.1	243.1	299.7	356.5	378.3	407.3	268.1
Current Account	-48.5	-82.5	-118.2	-105.8	-117.8	-128.4	-203.8	-292.8	-410.3	-393.4
Profits*	255.2	301.7	369.0	403.6	463.3	504.5	478.8	455.9	423.0	333.7

**nonfinancial sector*

These numbers show a benign economic development for the first part of the 1990s. Both business fixed net investment and profits performed splendidly. The trade deficit widened at a moderate pace. This was to change abruptly in 1997. All of a sudden, steeply rising imports sent the trade gap zooming. Since 1996, goods imports are up by 48%, and goods exported by 14%. Manifestly, this extraordinary import boom reflected exploding domestic demand.

Equally unusual was the simultaneous, sudden downturn in profits. Considering that it happened in a booming economy, this was most ominous. From the macroeconomic perspective, as explained, this had its most conspicuous cause in the trade deficit that since 1997 has skyrocketed from $128 billion to lately more than $500 billion at annual rate.

But didn't all that money that exited through the current account promptly return through the capital account, as foreigners bought American assets? Yes, but these flows match only in the balance of payments, not in the economy. The spending outflows come out of the economy's income stream that the capital inflows do not invalidate. Foreign purchases of U.S. assets may boost asset prices, but they add nothing to U.S. domestic incomes.

THE CRUCIAL DISEASE: OVERCONSUMPTION

We have identified declining net capital investment and the soaring trade deficit as the major causes of the U.S. profit carnage. Their negative influence started in the 1980s and worsened dramatically in the late 1990s. Yet there was a third major influence at work in the later part of the 1990s that supported profits. This was the consumer's borrowing binge that slashed his saving rate from 7–8% of disposable income to around 2% in 2000–01. Purchases with borrowed money, in contrast to purchases from income, add to profits.

Trying to assess the U.S. economy's profit prospects, we focus primarily on the three macro influences that we have described: changes in business net fixed investment, the trade deficit and private savings (businesses and individuals). In all three, the outlook is for worse, much worse, to come.

As to business net fixed investment, it slumped in 2001 to $268.1 billion, from $407.3 in the year before. The reason was a double whammy from sharply lower gross investment and sharply higher depreciation charges. In 2002, gross net fixed investment in the nonfinancial sector fell another $84 billion. Taking a rise in depreciation charges by at least $40–50 billion into account, net fixed investment may have plummeted to around $100 billion. As a share of GDP, that is close to nothing. This would savage profits.

What about the trade deficit? We have to say that the sharp acceleration of merchandise imports in the course of 2002, by 11%, has surprised and shocked us as it happed against GDP growth of 2.4%. Imports are rising almost five times faster than GDP.

We do not think that this is a mere coincidence. This extremely high and apparently worsening import bias of the U.S. economy has distinctly been operating for many years, and we are sure that it reflects something that we have always emphasized: America's alleged investment boom in the last few years is another myth.

America's long-term structural problem is the economy's strong consumption bias. Its implicit counterpart is a very low investment and export bias. For sustainable long-term growth, it would be necessary to reverse these trends. This was the declared aim of supply-side Reaganomics. What it actually achieved was the exact opposite. Consumption rose as a share of GDP, and this share has soared further in the 1990s.

Two numbers strikingly highlight America's gross imbalance between demand growth and supply-side growth. In the late 1990s, domestic spending expanded in real terms at an annual growth rate of 5%. This compared with an average annual rate of capital stock growth of around 2%. In relation to GDP, the capital stock is in a sharp fall.

Plainly obvious was also the specific demand component that overwhelmingly accounted for the protracted burst of domestic demand — the greatest consumer borrowing and spending binge of all times. America's crucial disease that explains everything else is grossly inflated consumer spending.

There are, of course, the huge capital inflows. Didn't they add to capital formation? Quite to the contrary, consumption's sharply growing share in GDP plainly attests to the fact that America has been selling its factories to foreigners in order to finance soaring consumption.

From a micro perspective, the American economy may be leaner and fitter, thanks to corporate restructuring, but the huge and still-rising trade deficit attests that its production capacity is totally inadequate in terms of the volume of its internationally competitive capacity.

Among the industrial countries, the United States traditionally has the highest consumption ratio and the lowest ratios of saving and investment. In the 1980s, there was wide agreement that this pattern ought to be reversed. This was the trumpeted aim of supply-side Reaganomics. Ironically, just the opposite happened. Consumption rose as a share of GDP. Still more ironically, its share soared even more in the 1990s. Measured by available savings and the actual net investment ratio, the U.S. economy's supply side is in shambles as never before.

MORE MALADJUSTMENT

We started with the question of what effectively caused the U.S. economy's downturn. Our answer was: It is primarily a correlated profits and capital spending crisis, and they both are the legacy of the bubble-related credit excesses that have further boosted consumption at the expense of available resources for investment and exports.

The next compelling question, of course, is whether or not these maladjustments are being remedied, giving hope for a sustained recovery. What America needs, in short, is lesser consumption and more capital formation that also allows for more exports. Adjustment takes time, but in the United States — see the plunging net investments and the soaring trade deficit, on the one hand, and new records in consumer borrowing, on the other —

the exact opposite is happening.

As to corporate profits, the macro influences are becoming increasingly negative. They are, for reasons explained, the accelerating slide in business net investment and the rising trade deficit. At the same time, a third, additional crunch is looming from a trend reversal in personal saving. Continuing losses on his stock holdings will, after all, force the consumer to replenish his wealth through higher saving from current income, implying correspondingly lower business revenues.

It is widely argued that the consumer's finances have remained in good shape because his real income growth has been well maintained at an annual rate of around 3%, and that debt service, thanks to a sharply lower interest rate debt service, is below former peaks. Given the economy's weakness, gains in disposable income are, indeed, astonishingly high. The realities are sharply lower gains in wage and salary disbursements, as against sharply higher governmental transfer payments and tax cuts. Besides, it has to be taken into account that consumer spending creates employment income. If that drops, wage payments will follow suit.

Yet there is a strong offsetting influence to rising personal saving. That's the soaring budget deficit. But while certainly cushioning the economy's downturn, its structural flip side is new, massive ravage of domestic saving, just the opposite of what is needed from a macro perspective. It is quite possible that the rising budget deficit is already overtaking the rise in personal saving, leaving America with negative net national savings for the first time ever.

CORPORATE DISSAVING

America is plainly in a correlated, structural crisis of profits and capital spending. In the preceding pages, we have traced what happened on the macroeconomic level that led to this combined malaise. An ultimate key cause we identified was a reckless overexpansion of consumer spending that left less and less resources for investments and exports. Its counterpart was shrinking net investments and soaring imports which together increasingly depressed profits.

But we hasten to add that macro influences were not alone in devastating America's capital base. A simultaneous, drastic change in corporate strategies for expansion worked in the same direction of diminished capital formation. Just as on the macro level, this bias also started in the 1980s, but equally it went in the late 1990s to extreme excess.

What happened in the corporations to do this? Unspectacular and slow organic business expansion through creating new capital stock increasingly gave way to strategies that aimed at faster expansion and profit growth through mergers and aquisitions. It ought to have been realized right from the outset that this shift in corporate growth strategies inherently implied diminished new investment and capital formation. But nobody cared.

Undeniably, these new corporate strategies worked, as intended, short-run wonders on stock prices. In no time, it became the global consensus view that these wonders to stock prices truly reflected new wonders in corporate efficiency, due to superior new corporate governance, inspired by categorical imperative imposed on corporate management that shareholder value is the key measure of success. Around the world, investors and corporations poured trillions of dollars into U.S. stocks to participate in the promised and expected wonders that were bound to happen to profits.

In a mindless chase for big and quick boosts to the share prices of their company, executives shifted toward rapid-fire expansion through stock purchases. Corporate America became addicted to stock buybacks, mergers and acquisitions.

Corporations borrowed as never before not to invest into new plant but to finance mergers, acquisitions and repurchases of their own stock. What's more, they paid ridiculously high prices. Trillions of dollars of such excess payments were capitalized in balance sheets as goodwill, actually worthless goodwill. Only its counterpart was real — soaring indebtedness involving soaring interest expenses in the long run.

In their three busiest years, 1998 to 2001, corporate deals totaled nearly $4 trillion — more than in the preceding 30 years combined. Of course, CEOs had to offer their shareholders some plausible reasons why they

pursued these purchases and, above all, why they typically paid prices vastly in excess of the previously prevailing price of the acquired firm's stock which, in turn, was already vastly in excess of book values.

The common rationale for this extraordinary generosity of the acquiring companies in the prices they paid for the stocks of the acquired firms was that grand synergy effects in the combined company, enhancing productivity and profits, would boost overall profits to a level that validates the high stock values. Typically, the measures trumpeted to achieve these effects were cost-cutting, downsizing and restructuring.

MACRO CONTRA MICRO

What went wrong? While the deal frenzy did, indeed, drive share values to fantastic levels, the expected and predicted profit miracle never materialized. Not only that, what materialized instead was America's worst profit performance in the whole postwar period. Profitability has slumped across all sectors of the economy.

It has all the time been a mystery to us how anybody with some knowledge in economics could put any faith in these boastful allegations of greater efficiency through these corporate strategies. Simply buying growth and profits by piling up mountains of debt is really schizophrenic macroeconomics whose perfectly predictable result was plunging profits in the aggregate. All this flagrantly defied even the most simple economic logic.

Speaking about wealth creation, it first of all needs a strict distinction between two different kinds. The one occurs inside the corporations and the economy in the form of creating productive, physical assets through saving and investment, and the other one takes place in the markets through rising asset prices, mainly of stocks or houses. It used to be a truism in economics that only new investment, adding to the economy's productive capacity, creates genuine wealth and future incomes.

To speak of rising stock and house prices as wealth creation is even in America a completely new mode that developed in the 1990s. As to house prices, their rise used to be called inflation. For sure, higher asset prices add to the wealth of their owners, but of course at the expense of future buyers; and above all, as compared with wealth creation in physical assets, this wealth creation though higher asset prices adds nothing to current and future incomes. From the macro perspective, it is really bubble wealth from which the economy as a whole gains nothing.

To say that the economy gains nothing is really a gross understatement. Phony bubble wealth tends to distort existing economic structures. In the case of Japan, it was gross overinvestment and malinvestment. In the current U.S. case, it is gross overconsumption, showing on the macro level the most spectacularly in the record current account deficit and the record-low rates of net national saving and net investment; and on the micro level, it shows above all in the record-high private indebtedness, devastated balance sheets and in the protracted profit crisis.

In our view all this has its main cause in the new equity culture that took possession of Wall Street and Corporate America. Promising profit wonders, it put executives under unprecedented pressure to deliver them. Effectively, it fostered a whole variety of new corporate practices believed to boost profits, which however were self-defeating and even destructive from the macroeconomic perspective.

Saying this, in particular the merger and acquisition mania and the new obsession with cost-cutting are in our mind. Apparently, one cannot stress often enough the crucial role of business fixed investment for creating business revenues and profits. Any cut in business spending is a cut in business revenue. Any cut in business net investment is an equal cut in business profits.

As to mergers and acquisitions, it has always been a compelling conclusion to us that they are completely unsuited to raise profits in the aggregate. In essence, they represent a meaningless exchange of ownership that, by itself, has nil economic effect. But they are done with the acquirer's explicitly declared intention to improve the profits of the combined firms through shrinking the cost-side. There never was, or is, any talk of investment plans. In general, cost-cutting certainly takes place. But it has apparently yet to be realized that this device, looking at businesses in the aggregate, equally cuts business revenues. From a macroeconomic perspective, it is self-defeating for profit creation.

It has never been investigated whether and to what extent merging firms actually curb their new investment spending on plant and equipment. Nobody asks, nobody cares; rising share prices are the only thing that matters. In our view, it is the most important question about mergers and acquisitions because whatever curtails capital formation does long-term damage to the economy. We are sure that acquisitions definitely diminish the interest of the acquiring firms in new investment.

In this way, the merger and acquisition mania has certainly substantially contributed to the poor capital stock growth. Considering the eminent importance of new investment not only for productivity and competitiveness, but also — via its revenue effects — for overall corporate profits, this must be regarded as a severe, though invisible and immeasurable, loss for the economy as a whole. It is really the decisive, structural damage. The wealth effects in the form of higher stock prices, on the other hand, stimulate higher consumer spending. These considerations lead to the conclusion that the merger and acquisition mania has also effectively fostered consumption at the expense of investment.

DEVASTATED BALANCE SHEETS

Earlier we asked what is impeding the U.S. economy's recovery. As explained and described, we see on the macroeconomic level — that is, in savings, capital formation and the trade deficit — only further maladjustment. The consumer has been beating ever-new borrowing records. At the same time, a soaring budget deficit is driving net national savings into negative territory for the first time ever. All these worsening single maladjustments have their common cause in the fact that the U.S. economy's central, macroeconomic maladjustment — a gross imbalance between consumption and investment — keeps going from bad to worse.

The corporate sector has retrenched by slashing its investment spending. Though this represents an adjustment, it is the least desirable one for the U.S. economy with its notoriously low capital formation. Yet it is widely hailed as a positive development that strengthens the corporate sector's badly weakened balance sheets. Another generally hailed feature is a rising cash flow, believed to improve liquidity.

On closer look, we see a drastic worsening of both business liquidity and profitability. As to cash flow, it is necessary to distinguish between two different components of totally different quality: depreciation charges and undistributed profits. First of all, depreciation charges are expenses, and second, they derive from obsolescent capital stock needing replacement. In reality, retained earnings are the only freely disposable component of cash flow. Also called business saving, they alone represent a net financial gain for the firm.

But this component of corporate cash flow in the United States has collapsed. Any increase comes from soaring corporate depreciation charges. What has happened to business savings net of depreciation charges is an outright disaster that most observers have yet to notice. Until the latter 1970s, they equaled on average 2.9% of GDP. In the 1980s, that was down to 1.8% of GDP. Lately, however, it is zero for businesses as a whole.

This is another very ugly financial development that everybody ignores. Confronted with plunging stock prices, corporate executives are trying to prop them up by maintaining or even raising their dividend payments. With profits plunging, retained earnings have melted to zero. But this overall picture for businesses as a whole conceals a dramatic, if not traumatic, deterioration in the nonfinancial sector. Here retained earnings have not only disappeared, but they have turned heavily negative because the companies are paying dividends increasingly in excess of their earnings. In other words, a sharply rising part of dividends is met with borrowed money.

But there are still two other major growth- and profit-damaging legacies from the merger and acquisition mania. These are badly ravaged balance sheets and consequential record-high interest expenses. They result from the practice that CEOs of the acquiring companies regularly paid premiums of 35–40% above the seller's market price before the announcement of the deal. The excess payment was buried in goodwill, worthless goodwill, of course.

There are no statistics about this grandiose waste of money. But corporate balance sheets offer a proxy: the difference between the increase in debts and the simultaneous increase in tangible assets. Between 1997 – 2002 (QIII), the debts of nonfinancial corporations have soared by $3,108.3 billion, or 47%. On the asset side of their

balance sheets, tangible assets (real estate, equipment and software, and inventories) rose by $1,451.7, or 17%. The difference is $1,756.6 billion. The outstanding feature on the asset side has been the exploding goodwill, hidden in the statistics under "miscellaneous assets."

What happens to interest expenses when corporations amass debts at a much faster rate than earning assets should be clear. Corporate net interest expenses are lately running at an annual rate of more than $190 billion, comparing with $119 billion in 1997. But after-tax profits were then around $300 billion, as against $190 billion currently.

Assessing the U.S. economic prospects, it has to be realized in the first place that the profit carnage is structural, not cyclical. We have identified four major profit-squeezing influences: the soaring trade deficit, declining gross investment, rising depreciation charges and record net interest expenses.

All four features have dramatically worsened in the past few years, ravaging both corporate balance sheets and profits. For a new substantial rise in profits, it needs a rather drastic improvement in at least some of these four accounts. This letter has been written with the question in mind whether or not the conditions for economic recovery in the United States are improving or worsening. We see more of the latter than of the former.

CONCLUSIONS:

The U.S. economy's weakness has two main sources: totally unfettered money and credit creation, on the one hand, and a general, excessive bias in favor of consumption and financial speculation at the expense of capital formation.

The merger and acquisition mania has been typical of this strong propensity. It was always in our view capitalism in perversity and stupidity that has in the long run effectively destroyed investment incentives (profits) and investment resources (saving). The reality behind building shareholder values was the greatest capital destruction.

It is widely agreed that a sustained U.S. economic recovery depends crucially on rebounding business fixed investment. Of course, this, in turn, depends crucially on strengthened corporate balance sheets and improving profits prospects.

The reality, however, is that both are dramatically worsening. After all, plunging stock prices oblige corporations to write off vast and increasing amounts of phony goodwill assets. While it does not burn cash, it burns capital. Cash, though, is increasingly burned through dividend payments in excess of corporate earnings.

At the same time, all macro and micro signs point to further sharp falls in stock prices and corporate profits. The U.S. economy is inexorably heading for its longest and deepest recession.

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